

OVERVIEW OF THE 2003-04 BUDGET BILL

SETTING A CONTEXT

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The State faces an extraordinarily difficult budget problem in 2003. To deal with it effectively, the Legislature must put the budget in a context that clarifies the problem and possible solutions.

Introduction. On February 3, the Legislature passed a package of bills to reduce current-year spending by \$3 billion. The package also clarified that the Director of Finance may raise the Vehicle License Fee (VLF) by \$4 billion during the relevant period. The package included Assembly Bills 4x, 6x, 8x, 10x, 11x and Senate Bill 10x. Taken together, these bills were the Legislature's initial response to the state's \$26 billion deficit.

On March 3, the Senate Budget and Fiscal Review Committee expects to begin its regular subcommittee process.

THE GOVERNOR’S BUDGET PROPOSAL: Progress since January 10 and Continuing Challenges for the Legislature

The Department of Finance estimates that the state starts the 2003-04 year with a carry-over *deficit* of over \$4 billion. The Governor proposes a comprehensive plan for eliminating the entire deficit by June 30, 2004. Below, we describe

- The General Fund condition,
- The Governor’s proposal, and
- Timing for legislative action on the Governor’s proposals.

Describing the General Fund Condition

The Department of Finance estimates that General Fund revenues will total \$69 billion in the budget year. This is five percent below current-year revenues.

Under the Governor’s proposal, General Fund spending falls to \$63 billion for 2003-04. This is nearly one-fifth lower than the estimated current-year budget. The magnitude of the reduction is without precedent.

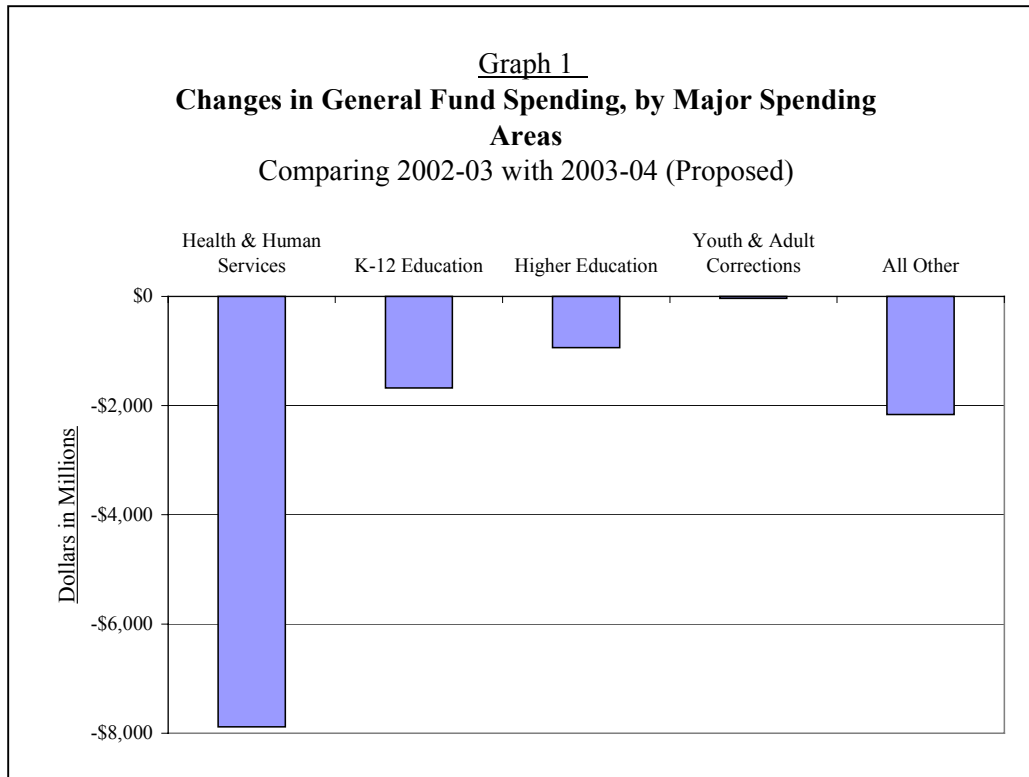
After accounting for the carry-over deficit (\$4.5 billion) and current-year encumbrances (\$1.5 billion), the state would end the year with a surplus of resources over expenditures of about \$500 million. Table 1 summarizes the General Fund condition if the Legislature adopted the Governor’s proposal. (See page 20 for a condition statement adjusted for the realignment transactions.)

Table 1
Comparison of General Fund Resources and Expenditures
Unadjusted General Fund Condition
 (does not assume the “Realignment” revenues and expenditures in 2003-04)
 Dollars in Millions

	<u>2002-03</u>	<u>2003-04</u> <i>(proposed)</i>	<u>Change</u>
Prior-Year Balance	-\$2,133	-\$4,451	109%
Revenues and Transfers	<u>73,144</u>	<u>69,153</u>	-5%
Total Resources Available	\$71,011	\$64,702	-9%
Expenditures	\$75,462	\$62,769	-17%
<i>Resources-Expenditures</i>	-4,451	1,933	
<i>Encumbrances</i>	1,402	1,402	
<i>Reserve</i>	-\$5,853	\$531	

State Spending Significantly Reduced from Current-Year Levels. The Governor proposes to reduce General Fund expenditures from \$75 billion in the current year to \$63 billion in the budget year. This represents a 17 percent reduction in General Fund spending. As displayed in Graph 1, all areas of the budget received a reduction from current-year funding levels.

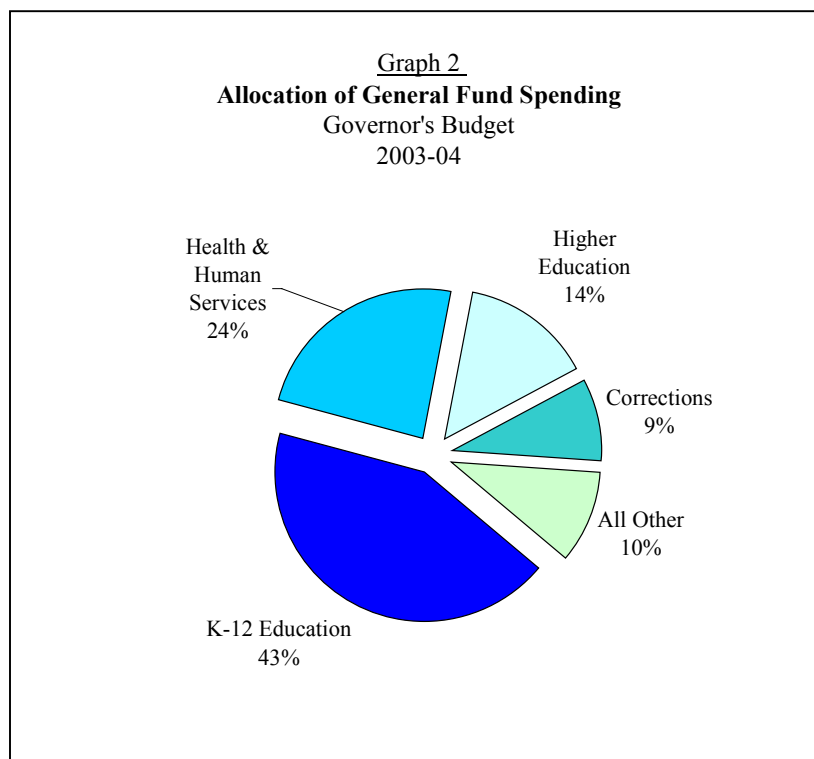
As proposed, Health and Human Services sustains the largest reduction, nearly \$8 billion (a 34 percent reduction) from current-year levels. K-12 education falls by \$1.7 billion (a six percent reduction). Higher Education is reduced by nearly \$1 billion (a ten percent reduction).



Governor Proposes To Concentrate General Fund Spending in Four Areas

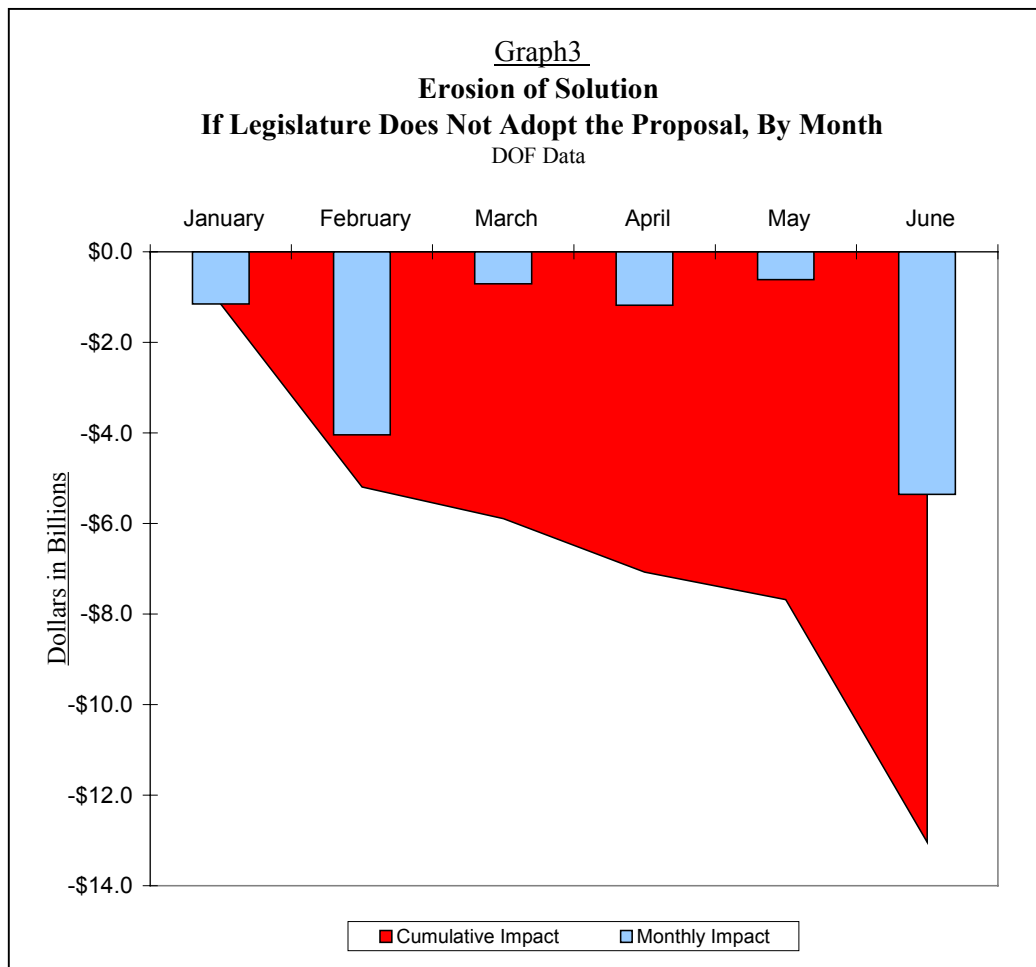
Looking at the 2003-04 budget proposal, four policy areas account for 90 percent of General Fund spending. Graph 2 identifies the relative spending in these areas. Specifically, in the 2003-04 budget:

- K-12 Education receives \$27 billion, accounting for 43 percent of General Fund spending,
- Health and Human Services receives \$15.1 billion, accounting for 24 percent of the total,
- Higher Education receives \$8.5 billion, accounting for 14 percent of the total, and
- Youth and Adult Corrections receives \$5.6 billion, accounting for nine percent of the total.



Relating the December Revision to the January Budget Proposal. In December, the Governor proposed a package of current- and budget-year reductions. The Governor asked that the December Revision be considered as part of the First Extraordinary Session. By proposing early action, the Governor hoped to begin reducing spending in January, rather than July, thereby spreading the reductions over an 18 month, rather than 12 month, period. As modified on January 10, the early reductions generate current-year savings of \$5.6 billion and budget-year savings of about \$12.6 billion. Taken together, this package would halve the deficit identified by the Governor.

While early action on this proposal is important, not all statutory and budget decisions contained in the December Revision must be taken by January 31 in order to achieve the full savings proposed by the Governor. Throughout the six month period starting in January, there will be monthly losses if the Legislature does not act on a timely basis. Specifically, according to the Department of Finance, if the Legislature does not act on the December Revision by January 31, it will lose about \$1.2 billion in solutions. Taking no action by February 28 will cost the state another \$4 billion, for a total loss of \$5.2 billion in solutions. Graph 3 summarizes the erosion of the solution over time. The bars in the graph represent the loss of solution if the Legislature does not act by the end of the month. The area in the background represents the cumulative loss by month.



Progress Since January 10. On February 3, the Legislature adopted a package of legislation which according to the Department of Finance provided savings of about \$3.5 billion in both the current and budget years. The package also clarified that the Director of Finance had the authority to raise the Vehicle License Fee (VLF) under specified circumstances. If the Director were to use this authority, it would provide an additional \$4 billion in budget savings. (The fate of this package was unknown at the time the committee published the *Overview*.) Relative to the Governor’s estimate of the deficit, the action to date would have “solved” about one-third of the deficit.

DEFINING THE PROBLEM: THE STATE EXPECTS TO RUN CHRONIC BUDGET DEFICITS

If statutory law were left unchanged, the state can expect spending to exceed available General Fund resources for the foreseeable future. The resulting operating deficits--in excess of \$15 billion annually--cannot be accommodated without major changes in law.

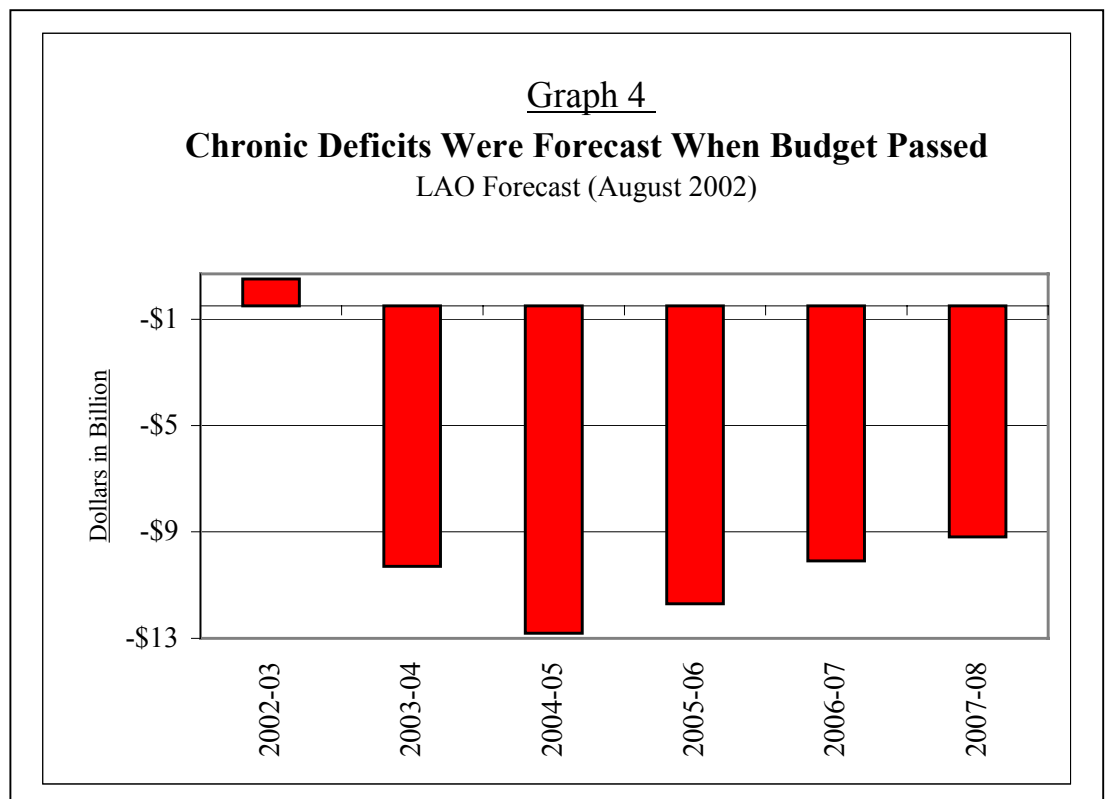
The deficits are deep and profound. Below, we discuss spending and revenue trends leading to the deficits, and describe how the Governor addressed the problem in his January 10 budget proposal.

History: What Happened Last Year?

When the Legislature considered the budget last August, the Analyst estimated that the state would sustain a surplus of about \$1 billion in 2002-03.

As displayed in Graph 4, the Analyst also made out-year

estimates which showed that, starting in 2003-04, the state would run a General Fund operating deficit for each year, beginning with an operating deficit of about



\$10 billion in 2003-04. Unless corrective actions were taken, it estimated that the operating deficit would rise to nearly \$13 billion in the following year.

After August, the LAO Predicted a Higher Budget-Year Deficit. Since August, estimates of the current- and budget-year deficits have worsened. In November, the Analyst estimated that the state's *current-year deficit* would be about \$6.1 billion. Of this amount, \$4.1 billion is attributable to a loss in revenues and about \$2 billion is attributable to higher-than-anticipated expenditures in the period ending June 30, 2003. Absent action by the Legislature in the current year, this deficit must be financed entirely in the budget year.

At the same time, the LAO raised its estimate of the *budget-year deficit* from \$10 billion to \$15 billion. Taken together, the LAO's estimates of the deficits have risen from a total of \$10 billion to a total of \$21 billion.

In January, the Analyst reported that the estimates are likely to change again. Although she has not revised her estimates yet, she expects that when the *Analysis of the 2003-04 Budget* is released on February 19 the estimate of the two-year deficit will increase by \$5 billion. Of this increase, about \$4 billion is the result of falling revenues and about \$1 billion can be attributed to higher expenditures. Consequently, the Legislature should anticipate that it will have to finance an 18-month deficit of at least \$26 billion.

How Big Is the Deficit?

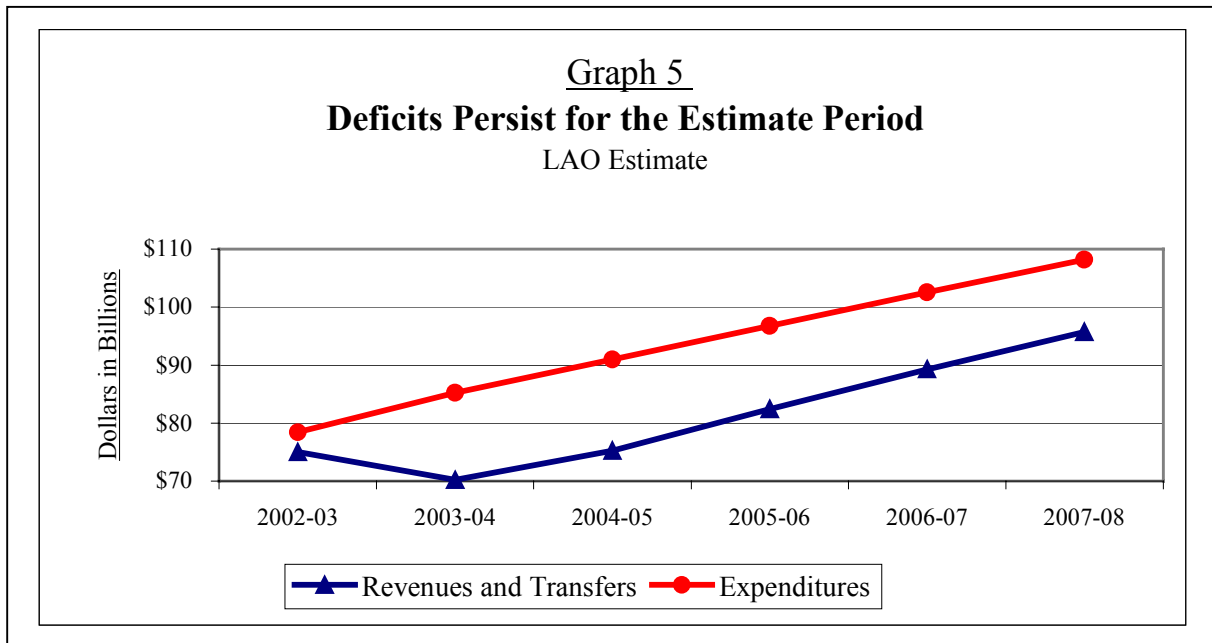
In January, the Governor estimated that the 18-month deficit was \$35 billion, while the LAO estimates about \$26 billion. The LAO explains that the DOF estimate is higher in the following way:

- ***\$5 Billion Is "Definitional."*** DOF assumed a higher spending "baseline." DOF added certain costs into the baseline, then "cut" the baseline. For example, DOF includes paying all deferred local mandate reimbursements in the baseline, then propose deferring the payments. The LAO did not assume the full repayment of mandates in its baseline, so the LAO budget-year baseline is lower.
- ***\$4 Billion Is "Forecasting Differences."*** DOF forecast lower revenues and estimated higher caseloads than did the LAO.

Next week, the Analyst will release a revised revenue forecast and expenditure estimate. At that time, the Legislature may consider whether the differences in the deficit are significant. If for example, the Legislature believes that budget-year revenues will be higher than those included in the Governor's budget, then the deficit problem—and solution—should be reduced accordingly.

Deficits Persist throughout the Foreseeable Future. According to the LAO, the deficits persist throughout the estimate period. As displayed in Graph 5, in each

year through 2007-08, the state will run annual deficits of between \$12 billion and \$16 billion.



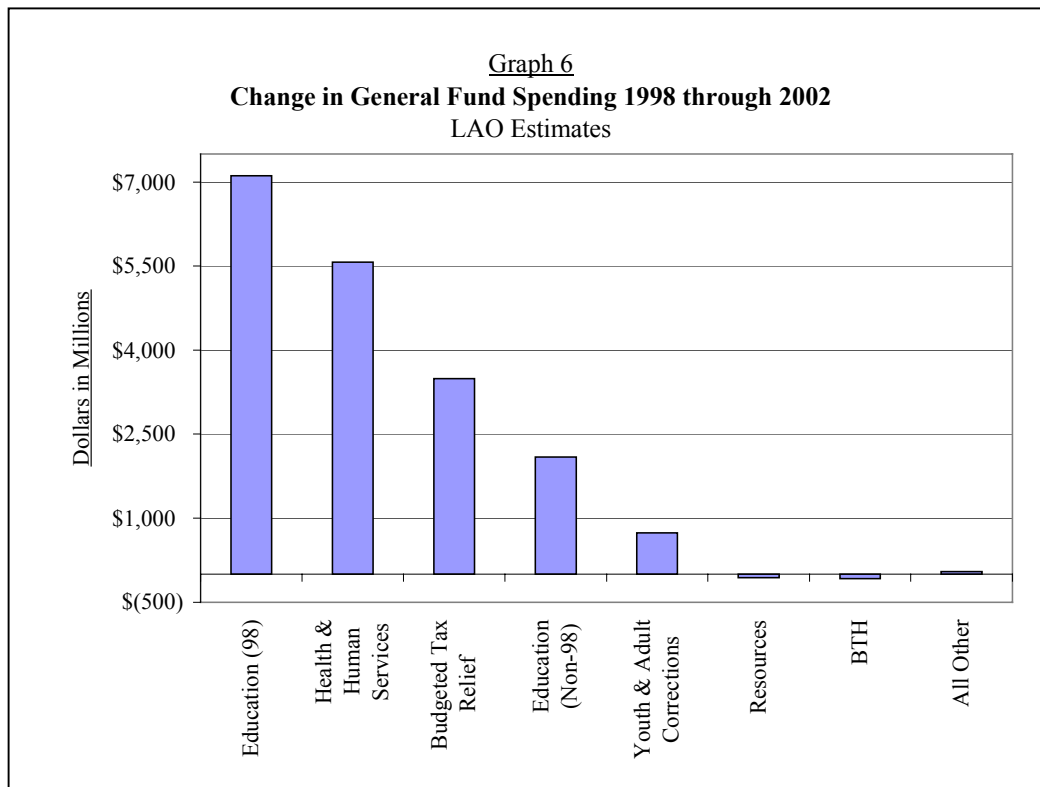
Deficits result from spending at rates greater than the revenue streams can support. Recent budget decisions and tax changes have contributed to the deficits. Below, we describe recent spending and revenue trends.

Trends in General Fund Spending

Since 1998, General Fund spending has increased from \$58 billion to \$77 billion, an increase of about \$19 billion (33 percent). Graph 6 displays the growth by policy areas, as estimated by the Legislative Analyst's Office (LAO). Education programs received the greatest amount of the increase. The Legislature allocated \$7.1 billion to Proposition 98-funded education programs. Other education spending, primarily spending on Higher Education, rose by an additional \$2.1 billion. As such, increased spending on education programs account for \$9.2 billion—nearly half—of the \$19 billion increase in spending since 1998.

Health and Human Services received \$5.6 billion of the increased General Fund spending (about 30 percent of the total growth). Most of this increase is attributed to changes in caseload and inflation. Over the period, the Legislature increased Medi-Cal provider rates, extended cost of living adjustments and expanded eligibility for the Healthy Families program.

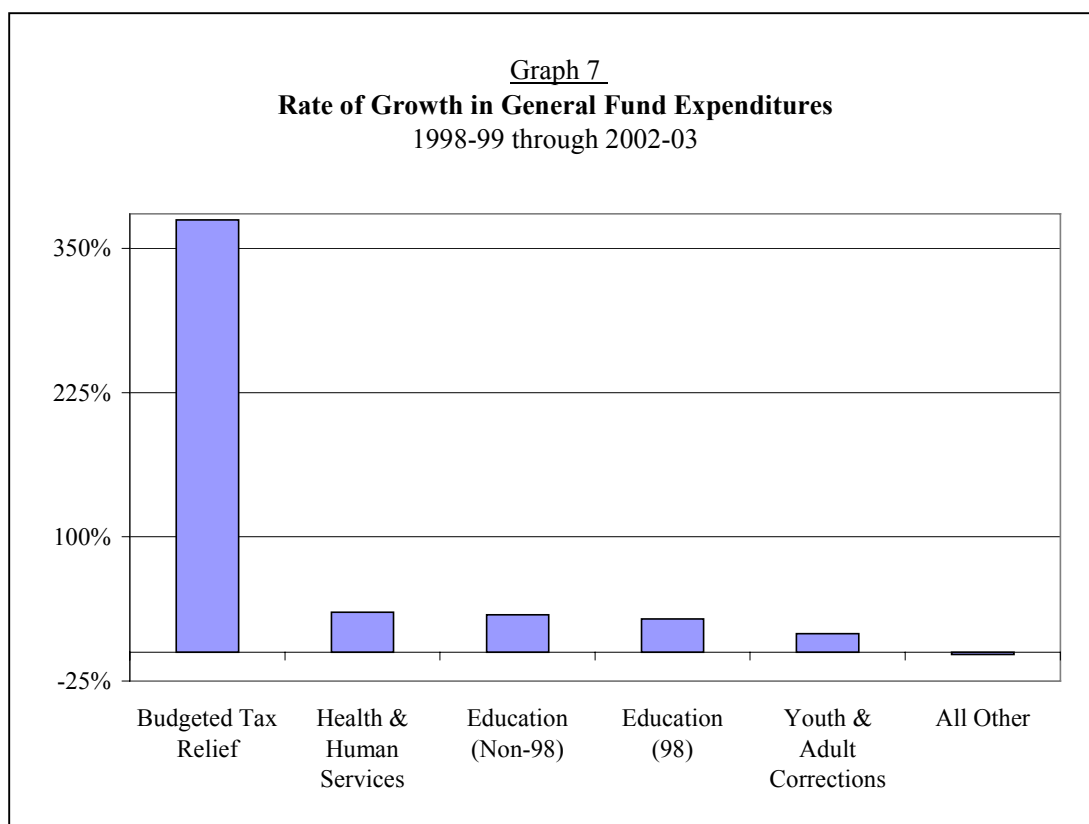
Since 1998, budgeted tax relief grew from \$931 million to \$4.4 billion, and accounts for 18 percent of the total growth in expenditures. (Budgeted tax relief are tax reductions which are *appropriated* in the budget act. The costs of tax relief not appropriated—like the Manufacturer’s Investment Credit (MIC) and Net Operating Loss (NOL)--are “off-budget,” and they do not appear in budget totals.)



The growth in spending for budgeted tax relief is primarily associated with the costs of backfilling local governments for their revenue losses associated with the reduction in the Vehicle License Fee (VLF).

Corrections spending grew by over \$700 million, accounting for about four percent of the growth over the period.

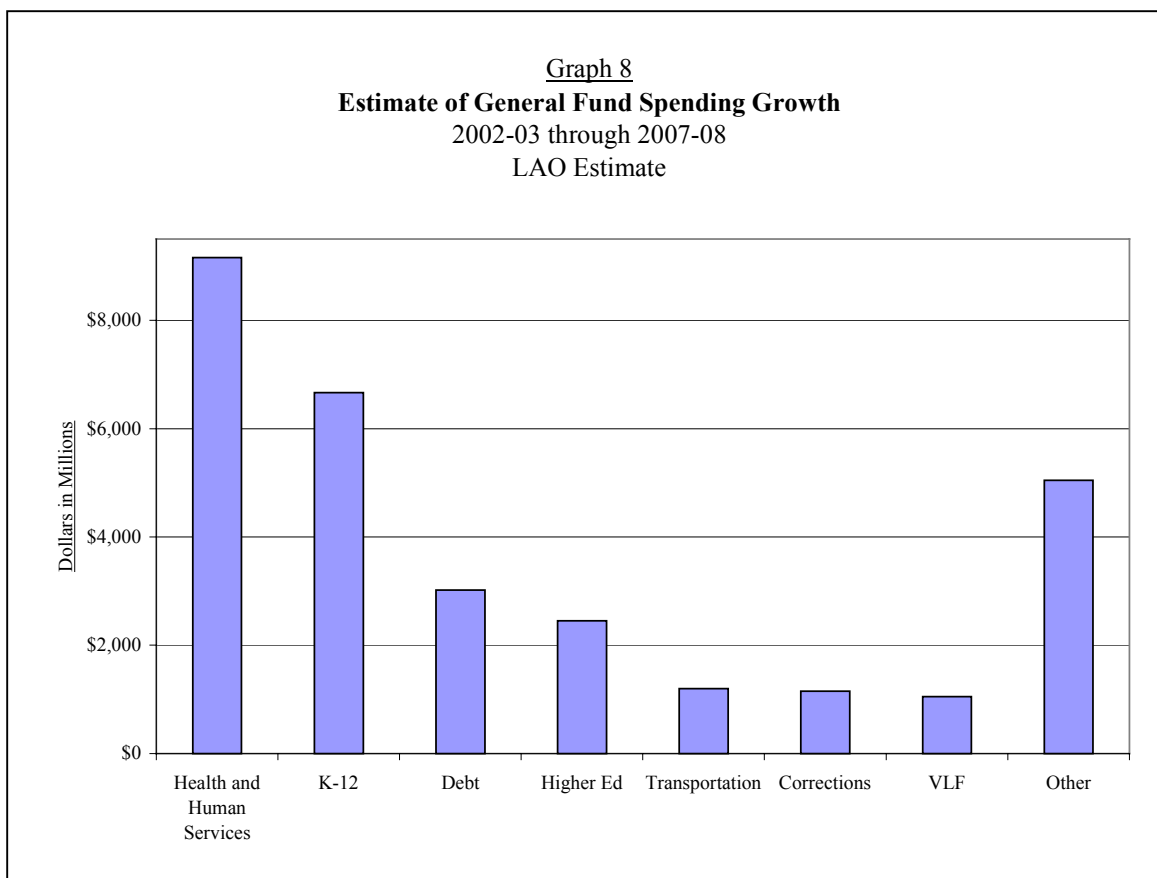
General Fund expenditures for resources, environmental protection, business, transportation and housing fell during the period.



An alternative way of looking at the spending changes since 1998 is to consider the rates at which programs grew. Though education, health and human services programs received the greatest *amount* of increased funding, budgeted tax relief sustained the highest growth *rate*. Budgeted tax relief has increased by 375 percent over the four year period, while education, health and human services programs grew by about 33 percent. Corrections spending grew about 16 percent. The rest of the budget contracted. Graph 7 compares the growth rates by major program area.

The LAO Spending Estimates. In November, the LAO forecast spending for the period ending June 30, 2008. The estimates, which assume no change in substantive law, identify about \$30 billion in new costs, a five-year growth rate of about 40 percent. The estimates, which assume no program expansions, merely account for changes in population and inflation. In Graph 8, we display the estimated growth in General Fund spending, by policy area.

The policy area with the greatest amount of growth will be Health and Human Services. The Analyst expects these programs to grow by about \$9.2 billion, a 42 percent rate of growth. In this policy area, the largest increase in spending would



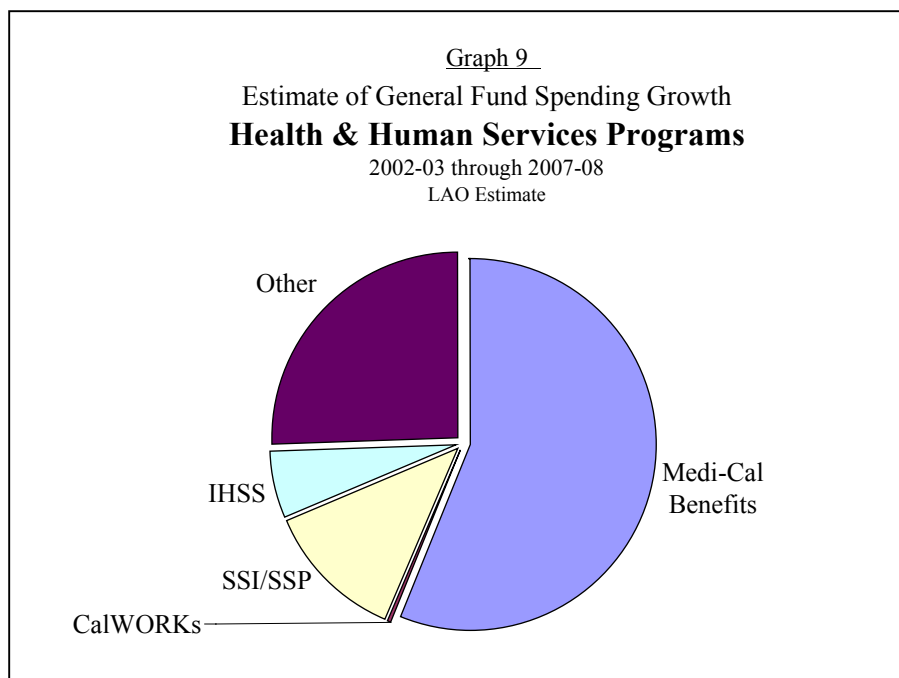
be associated with the cost of maintaining Medi-Cal benefits. The Analyst estimates that state cost for benefits will increase by about \$5.1 billion between 2002 and 2007. Costs will also increase rapidly for the provision of services under the SSI/SSP and IHSS programs as well. Graph 9 breaks out the estimate of increased spending for the Health and Human Services.

The Analyst expects K-12 education spending to grow by \$6.7 billion and higher education spending to grow by \$2.4 billion, for about a \$9.1 billion increase over the next five years.

Debt service costs will also account for a large share of growth in state spending. In recent years, the state has increased its borrowing significantly. Some of this is attributable to the costs of paying for the General Obligation bonds which were approved by the voters for school construction and resource acquisition. It is also associated with an increased reliance on lease-revenue bonds for accommodating the state's capital needs. In addition, as part of last year's budget compromise, the Treasurer restructured state debt which provided some short term budget relief, but increased the state's long-term costs.

Because the Legislature committed to increasing support for transportation, General Fund costs for transportation will increase by \$1.2 billion in 2007-08.

The Analyst also expects that the costs for the VLF backfill and Corrections will increase by about \$1 billion each in the next five years.



Other programs, including the costs for the General Fund support of employee compensation and local government mandates, will increase state costs by about \$5 billion.

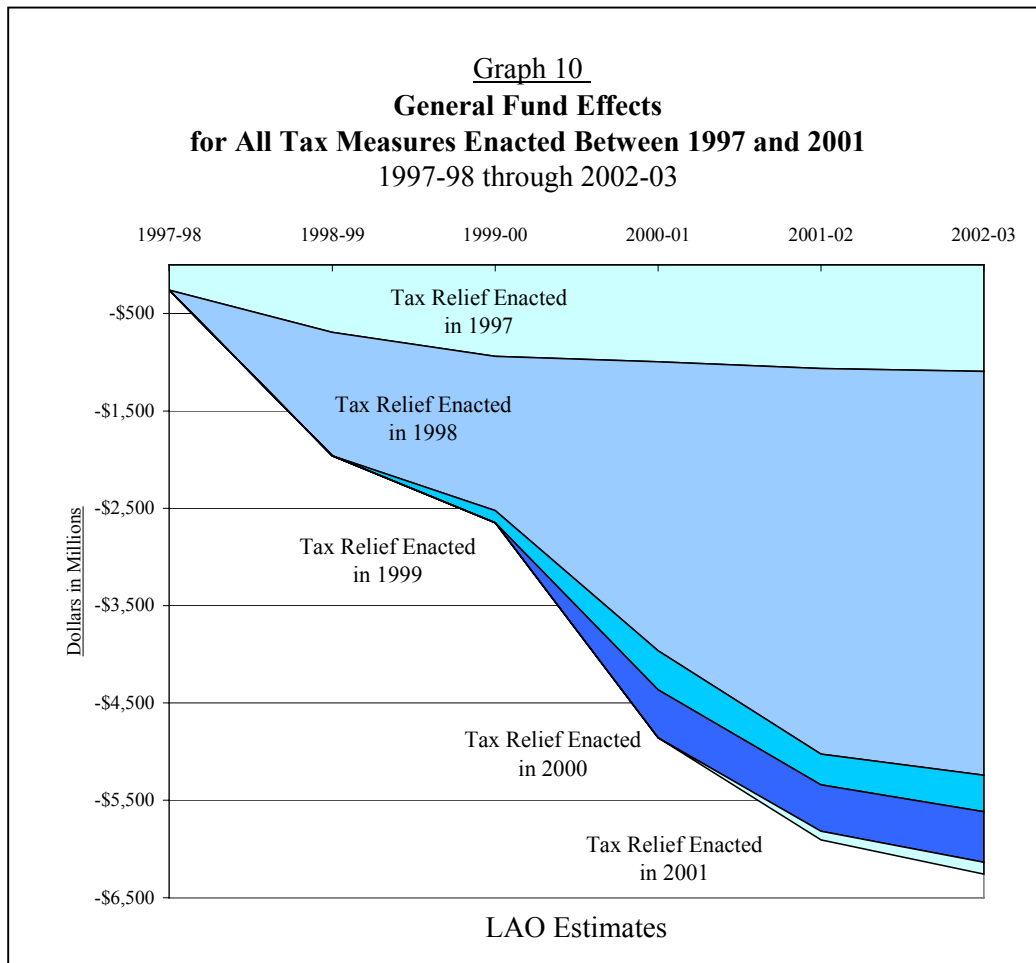
Revenue Trends

The Legislature reduced taxes between 1997 and 2001. For the 1997-98 fiscal year, the Legislature's actions reduced taxes by \$260 million. In each subsequent year, the tax relief provided by the 1997 changes reduced annual taxes by an even greater amount.

The Legislature approved additional tax reduction measures in 1998, 1999, 2000 and 2001. According to the Analyst, by the current and budget years, the relief provided in legislation enacted since 1997 had an annual value of \$6.3 billion and \$6.5 billion respectively. Graph 10 illustrates the effect of the tax changes enacted in the five-year period ending in 2001. Cumulatively in six years, the tax relief enacted between 1997 and 2001 reduced taxes by over \$28 billion. The effects of the tax reductions enacted since 1997 were offset in part by a temporary tax increase enacted in 2002. As part of the 2002 budget compromise, the Legislature temporarily suspended the application of the Net Operation Loss (NOL) and other

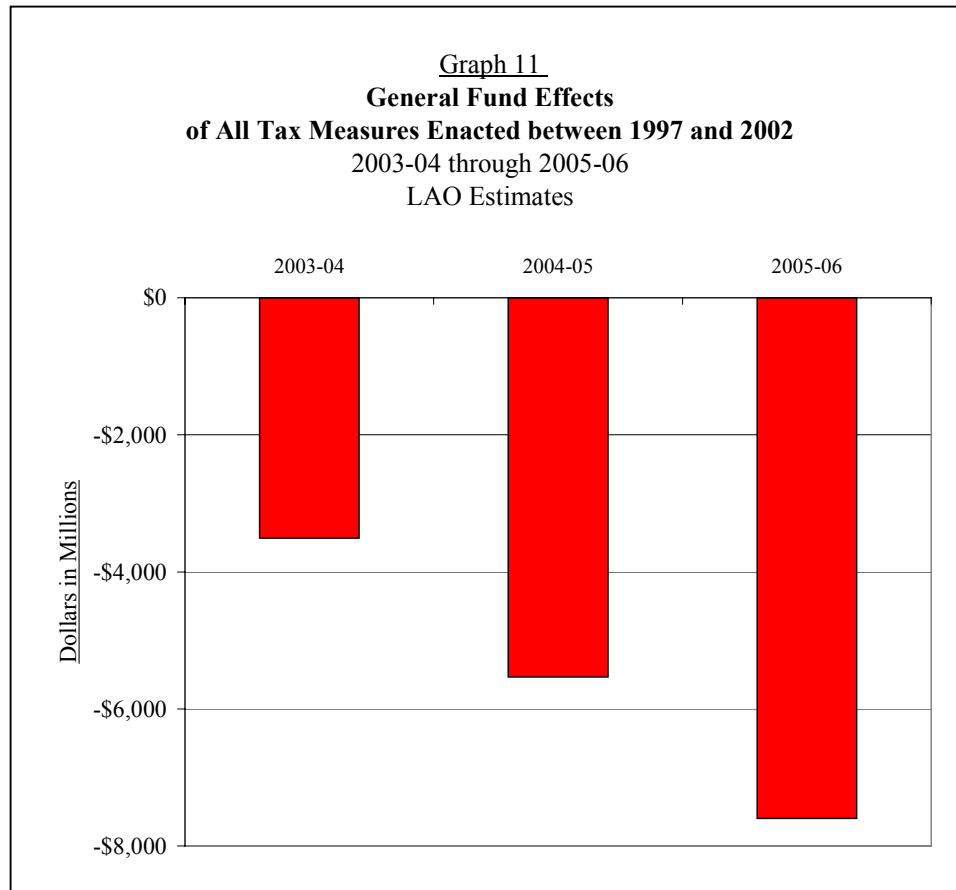
tax relief, and raised taxes by \$2.8 billion and \$1 billion in 2002-03 and 2003-04, respectively.

In subsequent years, the 2002 tax package provides for on-going reductions in taxes.



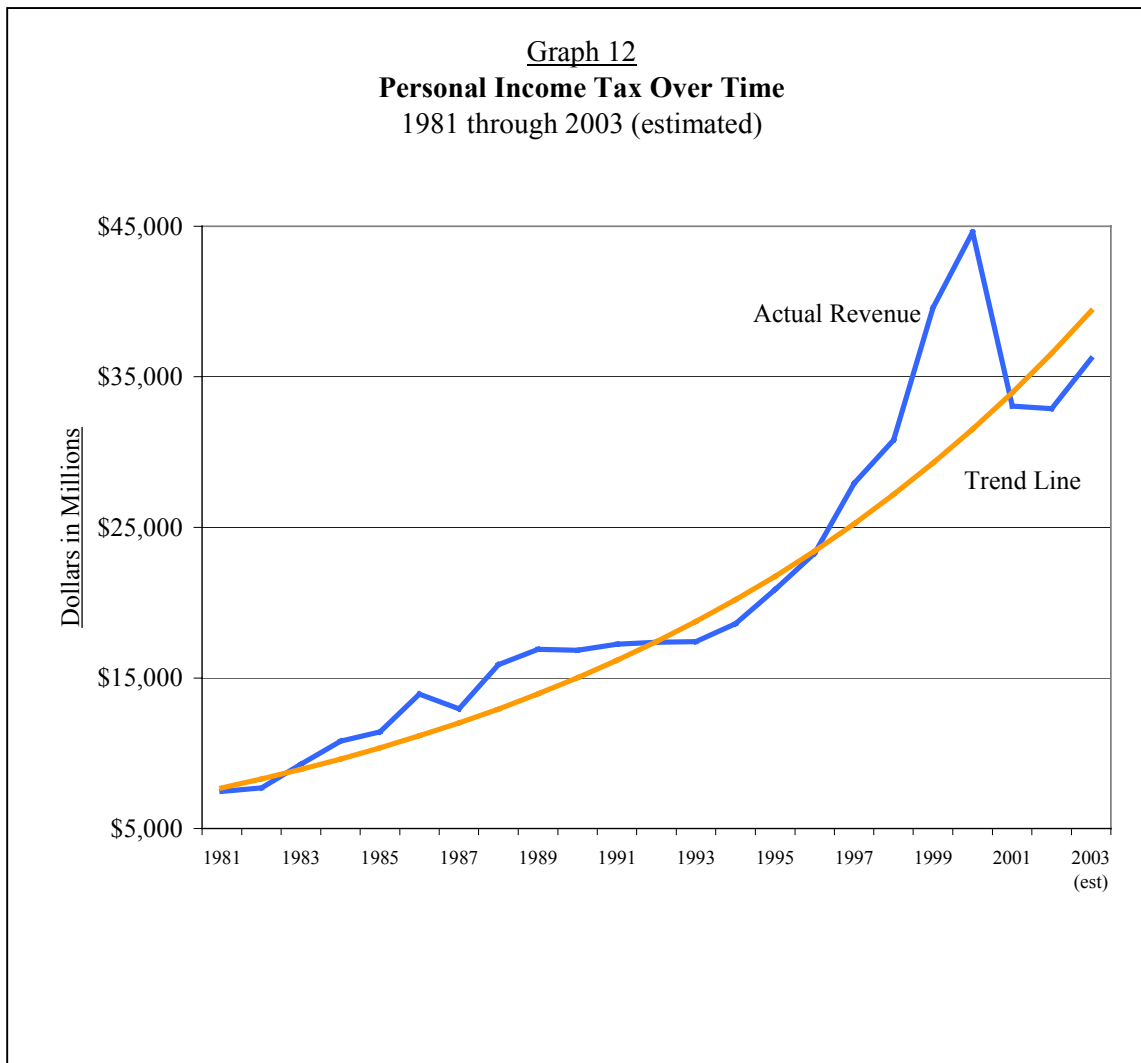
Tax Measures Enacted Between 1997 and 2002 Reduce Annual Tax Burdens by \$7.6 Billion. Taken together, the net effect of all tax measures enacted between 1997 through 2002 will reduce tax burdens by \$3.5 billion in the budget year. In 2005-06, when the temporary tax increases expire, tax measures enacted between 1997 and 2002 will reduce revenues by \$7.6 billion. Graph 11 illustrates the net effects of all tax measures enacted since 1997.

For a more extensive analysis of the recent tax changes and their fiscal effects, please see the revenue discussion in the section of this report entitled “Selected Major Issues.”



Did the State’s “Revenue Bubble” Burst in 2001? Between 1996 and 2000, the state experienced rapid growth in its personal income tax (PIT) revenue base. In those years, PIT revenues grew from \$23.3 billion to \$44.6 billion, a 92 percent increase. This growth was fueled by increased taxes on capital gains and stock options.

While the state experienced an unprecedented increase in income tax revenue, tax analysts were not certain whether the tax base had permanently or temporarily expanded. The nature of the expansion is important for determining whether the state could afford to make a permanent increase in programs or reduction in taxes. For example, if the base were permanently expanded, then the Legislature could expect an on-going source of higher revenue. On the other hand, if the increase in revenues were a temporary expansion of the tax base, then the Legislature should expect to return to a lower level of revenues in the future.



It now appears that the extraordinary revenue increases achieved in 1996 through 2000 were a temporary and unsustainable increase in the tax base. Since 2000, PIT revenues have dropped significantly. The amount collected in the 2001 and 2002 tax returns was lower than the amount collected in 1999, and only slightly more than the amount collected in 1998.

The extraordinary growth in the tax base in the late 1990's may have been a "bubble" which burst in 2001. The "bubble" is illustrated in Graph 12. The blue line plots actual PIT revenues. The orange line, plotting a 7.7 percent growth rate from amount collected in 1981, shows a constant-growth trend line. As displayed in the graph, the major variation from the trend line occurs during the period 1996

through 2000, forming a “bubble,” where actual revenues are significantly above the trend line.

If the capital gains phenomenon of the late-1990s turns out to be a one-time event, then the state’s long-term PIT revenues will more likely attain growth rates similar to the trend line displayed in Graph 12, rather than those actually achieved in the four-year period starting in 1996.

Putting the Governor’s Solutions in Context

The contraction of the PIT tax base, the growth in programs and the reduction in tax burdens created an on-going budget deficit. The Legislature first grappled with this deficit in 2001. In the budget year, the state faces a carryover deficit of nearly \$5 billion and the persistent on-going deficits. To address the one-time and on-going deficits, the Governor proposed the following budget adjustments in the 18-month period starting January 1, 2003:

- ***Program Reductions.*** The Governor cuts programs by nearly \$14 billion. Of this amount, about \$5.5 billion is associated with the current-year budget and must be enacted before June 30, 2003. We assume the entire budget-year amount can be scored as a permanent reduction.
- ***Revenues.*** In the current year, the Governor proposes an increase in revenues of \$200 million and \$10.1 billion in the budget year. Of these increases, \$8.2 billion would finance realignment. Presumably, the entire budget-year amount is permanent.
- ***Local Government Shifts.*** By reducing the VLF backfill, shifting revenues from redevelopment agencies and eliminating certain subventions, the Governor shifts about \$5 billion of the problem to local governments. This total does not include mandate deferrals. (The deferrals are included in the description below under loans.) About \$3.3 billion of this shift reduces on-going General Fund deficit.
- ***Fund Shifts.*** The Governor proposes to increase student fees in higher education, trial courts, resources programs and the Department of Industrial Relations. He proposes shifting the costs of child care to the federal government and moves capital outlay projects to a lease-revenue basis. These shifts provide \$2.2 billion in solution. About \$1.4 billion is

attributable to the budget year. Presumably most of the budget-year solution provides permanent deficit reduction.

- ***Loans and Borrowing.*** The Governor proposes to defer payments on mandates and retirement contributions for a budget year savings of about \$3.3 billion. None of this relief provides permanent, on-going deficit relief.

Table 2 summarizes the Governor's proposal by fiscal year.

Because the Legislature expects to address both the one-time carry-over deficit and the chronic deficit, it will be important for the Legislature to keep a tally of one-time and on-going reductions. While staff have not completed their analysis of the Governor's budget, some preliminary conclusions can be drawn.

The current-year proposals are, by their nature, one-time in their impact on the out-year deficit. They can all be scored as addressing the carry-over deficit. Assuming all the program reductions, taxes and shifts in the budget year are permanent, the Governor's proposal provides \$24 billion in on-going budget relief.

<p style="text-align: center;"><u>Table 2</u> Budget Proposals Addressing the Deficit Impact in Current and Budget Years LAO Estimates Dollars in Billions</p>				
	<u>Current Year</u>	<u>Budget Year</u>	<u>Totals</u>	
Program Reductions	\$ 2.7	\$ 11.0	\$	13.7
Taxes, Transfers and Other Revenues	0.2	10.1		10.3
Local Government Shifts	1.8	3.3		5.1
Fund Shifts	0.8	1.4		2.2
Loans and Borrowing		<u>3.3</u>		<u>3.3</u>
Totals	\$ 5.5	\$ 29.1	\$	34.6

Accounting for the Realignment Transaction in the General Fund Condition Statement. The General Fund condition changes if the realignment proposal is accounted for in the condition statement. By including the Governor's realignment proposal in the statement, both expenditures and resources increase. This adjustment facilitates comparisons with the current year and may be a more appropriate reflection of the tax change.

The Governor proposes to shift responsibility for several state programs to local governments. He would eliminate about \$8 billion from state General Fund spending and make local governments responsible for administering these programs. At the same time, he proposes to raise state-levied taxes by about \$8 billion. The new tax revenues would be deposited in a special fund to be earmarked for allocation to local government.

If the General Fund condition, as displayed in Table 1, were adjusted to reflect the realignment transaction, revenues and spending would be significantly increased. Specifically, after accounting for realignment described in the *Governor's Budget Summary*, revenues increase by three percent between the current year and the budget year. Expenditures fall by six percent. Please see Table 3 for a display of this adjusted General Fund Condition.

Table 3
Comparison of General Fund Resources and Expenditures
Adjusted General Fund Condition
(Assumes the Realignment Transaction)
Dollars in Millions

	<u>2002-03</u>	<u>2003-04</u>	<u>Change</u>
Carry Over Deficit	-\$2,133	-\$4,451	
Revenues and Transfers	73,144	69,153	
Realignment Revenues		8,334	
Total, Resources	\$71,011	\$73,036	2.9%
General Fund Expenditures	\$75,462	\$62,749	
Realignment Expenditures		8,154	
Total, Expenditures	75,462	70,903	-5.9%

HOW CAN THE LEGISLATURE PROCEED?

The Senate's review of the budget typically begins the first week of March. The budget subcommittees work with the Administration and the Legislative Analyst's Office to develop an agenda for each department in the budget.

As the subcommittees begin their work, the Legislature must consider the following broad questions:

- *Determine How Quickly To Re-Balance the Budget.* The structural deficit is deep and profound. The Legislature must consider whether it is most prudent to eliminate the accumulated deficit entirely during 2003-04 or to reduce the deficit in stages over several years.
- *Retire the Current-Year Deficit.* The state starts the new fiscal year with a carryover deficit of about \$4.5 billion. The carryover deficit can be addressed with either one-time budget cuts (such as reductions to capital outlay projects) or with on-going reductions.
- *Address the Chronic Deficit.* To address the chronic deficit averaging around \$15 billion, the Legislature must take action to reduce annual spending by \$15 billion, raise annual tax revenue by \$15 billion or use a combination of spending cuts and tax increases to close the gap between expenditures and revenues. The chronic deficit cannot be addressed with one-time solutions.
- *Consider the Circumstances when Short-Term "Solutions" Create Long-Term "Problems."* Based on the Analyst's estimates, the state cannot expect that the state's fiscal condition will improve in the foreseeable future. Even if the economy were to improve, the Legislature would still face chronic deficits.

Solutions which shift costs beyond June 30, 2004 may help balance the 2003-04 budget, but exacerbate the problem in outyears. The Governor's proposal to issue a pension obligation bond is such a measure. Under the proposal, the state would sell \$1.5 billion in *taxable* bonds. With the proceeds of the sale, the state would make its payment to the state's retirement systems. The bonds, carrying an interest rate of six percent (about three times the interest paid on the energy bonds issued last Autumn), the state would repay the bondholders over a 20

year period. This proposal provides budget relief in the current year but costs the state for the next 20 years.

Practically speaking, before the subcommittees begin their work, the Senate may want to answer the following questions about how the subcommittees should proceed:

1. *Will There Be a Revenue Increase?* To balance the budget, the Governor proposes increasing taxes by \$8.2 billion, raising fees by millions of dollars and assessing gaming interests \$1.5 billion. To what extent will the Legislature increase revenues?
2. *Should Local Governments Participate in the Solution?* The Governor proposes shifting about \$5 billion in revenue from local government to state activities. The shifts are from local discretionary revenues. To what extent will the Legislature act to reduce local discretionary revenue?
3. *Can the Federal Government “Help”?* In the early 1990s, Governor Wilson assumed that the federal government could provide additional assistance to the state to offset the cost of federal immigration policy. Under what circumstances is it likely that the federal government will provide greater assistance to California? For example:
 - Can the state restructure its programs so it can increase federal reimbursements for state costs?
 - Should the Legislature adjust the state tax structure to increase those state taxes which are deductible on the federal income tax and lower the tax which are not deductible?

To the extent the Legislature cannot increase revenues, shift costs to locals or secure additional federal assistance, then it must consider reducing programs more than proposed by the Governor.

Analysis prepared by John Decker, Senate Budget and Fiscal Review